

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Note 3. Portfolio, continued

The underlying rating classes of the CMBS bonds at value at June 30, 2002 and December 31, 2001 were as follows:

	2002		2001	
	Value	Percentage of Total	Value	Percentage of Total
(\$ in thousands)				
BB+	\$ 28,668	5.1%	\$ 24,785	4.4%
BB	40,701	7.3	69,404	12.4
BB-	33,452	6.0	67,460	12.1
B+	123,056	21.9	103,560	18.6
B	158,035	28.2	131,362	23.5
B-	79,664	14.2	73,572	13.2
CCC	9,119	1.6	8,893	1.6
Unrated	88,195	15.7	79,310	14.2
Total	<u>\$560,890</u>	<u>100.0%</u>	<u>\$558,346</u>	<u>100.0%</u>

At June 30, 2002 and December 31, 2001, the underlying pools of mortgage loans that are collateral for our CMBS bonds consisted of approximately 4,100 and 3,800 commercial mortgage loans with a total outstanding principal balance of \$22.9 billion and \$20.5 billion, respectively. At June 30, 2002 and December 31, 2001, 0.75% and 0.52%, respectively, of the mortgage loans in the underlying collateral pool for the Company's CMBS bonds were over 30 days delinquent or were classified as real estate owned. The property types and the geographic composition of the mortgage loans in the underlying collateral pool calculated using the outstanding principal balance at June 30, 2002 and December 31, 2001 were as follows:

	2002	2001
Property Type		
Retail	31%	31%
Housing	27	27
Office	21	22
Hospitality	7	7
Other	14	13
Total	<u>100%</u>	<u>100%</u>

Geographic Region		
West	31%	32%
Mid-Atlantic	25	24
Midwest	22	21
Southeast	17	17
Northeast	5	6
	<hr/>	<hr/>
Total	100%	100%
	<hr/>	<hr/>

The Company's yield on its CMBS bonds is based upon a number of assumptions that are subject to certain business and economic uncertainties and contingencies. Examples include the timing and magnitude of credit losses on the mortgage loans underlying the CMBS that are a result of the general condition of the real estate market (including competition for tenants and their related credit quality) and changes in market rental rates. The initial yield on each CMBS bond has been computed assuming an approximate 1% loss rate on its entire underlying collateral mortgage pool, with the estimated losses being assumed to occur in three equal installments in years three, six and nine. As each CMBS bond ages, the amount of losses and the expected timing of recognition of such

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Note 3. Portfolio, continued

losses will be updated, and the respective yield will be adjusted as necessary. As these uncertainties and contingencies are difficult to predict and are subject to future events which may alter these assumptions, no assurance can be given that the anticipated yields to maturity will be achieved.

Collateralized Debt Obligations. At June 30, 2002, the Company owned preferred shares in three collateralized debt obligations ("CDOs") secured by investment grade unsecured debt issued by various real estate investment trusts ("REITs") and investment and non-investment grade CMBS bonds. The investment grade REIT debt collateral consists of \$852,826,000 issued by 39 REITs. The investment grade CMBS collateral consisted of bonds with a face amount of \$402,142,000 issued in 26 separate CMBS transactions. The non-investment grade CMBS collateral consists of BB+, BB and BB- CMBS bonds with a face amount of \$405,032,000 that were issued in 30 separate CMBS transactions ("CMBS Collateral"). Included in the CMBS Collateral for the CDOs are \$393,832,000 of CMBS bonds that are senior in priority of repayment to certain lower rated CMBS bonds held by the Company, which were issued in 22 separate CMBS transactions. The preferred shares are junior in priority for payment of principal to the more senior tranches of debt issued by the CDOs. To the extent there are defaults and unrecoverable losses on the underlying collateral resulting in reduced cash flows, the preferred shares will bear this loss first. At June 30, 2002, the Company's preferred shares in the CDOs were subordinate to approximately 95% of the more senior tranches of debt issued by the CDOs. The yield on the CDOs at June 30, 2002 and

December 31, 2001 was 17.2% and 16.9%, respectively.

The Company acts as the directing certificate holder for the CMBS bonds and as the disposition consultant with respect to two of the CDOs, which allows the Company to approve disposition plans for individual collateral securities. For these services with respect to the CDOs, the Company collects annual fees based on the outstanding collateral pool balance, and for the six months ended June 30, 2002, this fee totaled \$160,000.

Loans

The commercial mortgage loan portfolio contains loans that were originated by the Company or were purchased from third-party sellers.

At June 30, 2002 and December 31, 2001, approximately 75% and 25% and 76% and 24%, of the Company's commercial mortgage loan portfolio was composed of fixed and adjustable interest rate loans, respectively. As of June 30, 2002 and December 31, 2001, workout loans, or those loans in Grade 4 and 5, with a value of \$15,860,000 and \$15,241,000, respectively, were not accruing interest.

The property types and the geographic composition securing the commercial mortgage loan portfolio at value at June 30, 2002 and December 31, 2001 were as follows:

	<u>2002</u>	<u>2001</u>
Property Type		
Office	28%	34%
Hospitality	28	25
Retail	24	21
Recreation	3	4
Other	17	16
	<u>100%</u>	<u>100%</u>
Total		

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Note 3. Portfolio, continued

Geographic Region		
Southeast	40%	36%
Mid-Atlantic	17	23
West	23	20
Midwest	13	16
Northeast	7	5
	<u>100%</u>	<u>100%</u>
Total		

Residual Interest

At June 30, 2002 and December 31, 2001, the residual interest consisted of the following:

	2002		2001	
	Cost	Value	Cost	Value
(in thousands)				
Residual interest	\$68,853	\$68,853	\$68,853	\$68,853
Residual interest spread	488	189	1,326	1,026
Total	<u>\$69,341</u>	<u>\$69,042</u>	<u>\$70,179</u>	<u>\$69,879</u>

The residual interest primarily consists of a retained interest totaling \$68,853,000 from a 1998 asset securitization whereby bonds were sold in three classes rated AAA, AA and A. The residual interest represents a right to cash flows from the underlying collateral pool of loans after these senior bond obligations are satisfied. At June 30, 2002, two classes of bonds rated AAA and AA+ are outstanding, for total bonds outstanding of \$29,600,000. The Company has the right to call the bonds when the outstanding bond balance is less than \$23,900,000. Once the bonds are fully repaid, either through the cash flows from the securitized loans or due to the Company calling the bonds, the remaining loans in the trust will be returned to the Company as payment on the residual interest.

The Company sold \$295 million of loans, and received cash proceeds, net of costs, of approximately \$223 million in January 1998. The Company retained a trust certificate for its residual interest in a loan pool sold, and will receive interest income from this residual interest as well as the residual interest spread ("Residual") from the interest earned on the loans sold less the interest paid on the bonds over the life of the bonds. As of June 30, 2002 and December 31, 2001, the mortgage loan pool had an approximate weighted average stated interest rate of 9.3%. The outstanding bond classes sold had an aggregate weighted average interest rate of 6.7% and 6.6% as of June 30, 2002 and December 31, 2001, respectively.

The Company uses a discounted cash flow methodology for determining the value of its retained Residual. In determining the cash flow of the Residual, the Company assumes a prepayment speed of 15% after the applicable prepayment lockout period and credit losses of 1% or approximately \$1.1 million of the total principal balance of the underlying collateral throughout the life of the collateral. These assumptions result in an expected weighted average life of the bonds of 0.5 years. The value of the resulting Residual cash flows is then determined by applying a discount rate of 9% which, in the Company's view, is commensurate with the market risk of comparable assets.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Note 4. Debt

The Company records debt at cost. At June 30, 2002 and December 31, 2001, the Company had the following debt:

	2002		2001	
	Facility Amount	Amount Drawn	Facility Amount	Amount Drawn
(in thousands)				
Notes payable and debentures:				
Unsecured long-term notes payable	\$ 694,000	\$ 694,000	\$ 694,000	\$ 694,000
SBA debentures	101,800	94,500	101,800	94,500
Auction rate reset note	75,000	75,000	81,856	81,856
OPIC loan	5,700	5,700	5,700	5,700
Total notes payable and debentures	876,500	869,200	883,356	876,056
Revolving line of credit	527,500	139,750	497,500	144,750
Total	<u>\$1,404,000</u>	<u>\$1,008,950</u>	<u>\$1,380,856</u>	<u>\$1,020,806</u>

Notes Payable and Debentures

Unsecured Long-Term Notes Payable. The Company issued unsecured long-term notes to private institutional investors. The notes require semi-annual interest payments until maturity and have original terms of five or seven years. At June 30, 2002, the notes had remaining maturities of one to four years. The weighted average fixed interest rate on the notes was 7.6% at June 30, 2002 and December 31, 2001. The notes may be prepaid in whole or in part, together with an interest premium, as stipulated in the note agreement.

SBA Debentures. At June 30, 2002 and December 31, 2001, the Company had debentures payable to the SBA with terms of ten years and at fixed interest rates ranging from 5.9% to 8.2% and 2.4% to 8.2%, respectively. At June 30, 2002, the debentures had remaining maturities of three to ten years. The weighted average interest rate was 7.0% and 6.7% at June 30, 2002 and December 31, 2001, respectively. The debentures require semi-annual interest-only payments with all principal due upon maturity. The SBA debentures are subject to prepayment penalties if paid prior to maturity. At June 30, 2002, the Company has a commitment from the SBA to borrow up to an additional \$7,300,000 above the amount outstanding. The commitment expires on September 30, 2005.

Auction Rate Reset Note. The Company has an Auction Rate Reset Senior Note Series A that matures on December 2, 2002, and bears interest at the three-month London Interbank Offered Rate ("LIBOR") plus 1.75%, which adjusts quarterly. Interest is due quarterly and the Company, at its option, may pay or defer such interest payments. The amount outstanding on the note will increase as interest due is deferred. Deferred interest may be repaid at any time without penalties.

As a means to repay the note, the Company has entered into an agreement with the placement agent of this note to serve as the placement agent on a future issuance of \$75.0 million of debt, equity or other securities in one or more public or private transactions. Alternatively, the Company may repay the note in cash without conducting a capital raise. If the Company chooses to pay in

cash without conducting a capital raise, the Company will incur additional expense of approximately \$2,063,000.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Note 4. Debt, continued

Scheduled future maturities of notes payable and debentures at June 30, 2002, are as follows:

Year	Amount Maturing (in thousands)
2002	\$ 75,000
2003	140,000
2004	221,000
2005	179,000
2006	180,700
Thereafter	73,500
Total	<u>\$869,200</u>

Revolving Line of Credit

The Company has an unsecured revolving line of credit for \$527,500,000. The facility may be expanded up to \$600,000,000 at the Company's option. The facility bears interest at a rate equal to (i) the one-month LIBOR plus 1.25% or (ii) the higher of (a) the Bank of America, N.A. prime rate or (b) the Federal Funds rate plus 0.50%. The interest rate adjusts at the beginning of each new interest period, usually every thirty days. The interest rates were 4.1% and 3.2% at June 30, 2002 and December 31, 2001, respectively, and the facility requires an annual commitment fee equal to 0.25% of the committed amount. The line expires in August 2003, and may be extended under substantially similar terms for one additional year at the Company's sole option. The line of credit requires monthly interest payments and all principal is due upon its expiration.

The average debt outstanding on the revolving line of credit was \$67,710,000 and \$106,338,000 for the six months ended June 30, 2002 and for the year ended December 31, 2001, respectively. The maximum amount borrowed under this facility and the weighted average interest rate for the six months ended June 30, 2002 and for the year ended December 31, 2001, were \$145,250,000 and \$213,500,000, and 3.2% and 5.4%, respectively.

The Company has various financial and operating covenants required by the revolving line of credit and the notes payable and debentures. These covenants require the Company to maintain certain financial ratios, including debt to equity and interest coverage, and a minimum net worth. The Company's credit facilities limit its ability to declare dividends if the Company defaults under certain provisions. As of June 30, 2002, the Company was in compliance with these covenants.

Note 5. Preferred Stock

Allied Investment has outstanding a total of 60,000 shares of \$100 par value, 3% cumulative preferred stock and 10,000 shares of \$100 par value, 4% redeemable cumulative preferred stock issued to the SBA pursuant to Section 303(c) of the Small Business Investment Act of 1958, as amended. The 3% cumulative preferred stock does not have a required redemption date. Allied Investment has the option to redeem in whole or in part the preferred stock by paying the SBA the par value of such securities and any dividends accumulated and unpaid to the date of redemption. The 4% redeemable cumulative preferred stock has a required redemption date in June 2005.

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**Note 6. Shareholders' Equity**

Sales of common stock for the six months ended June 30, 2002, and the year ended December 31, 2001 were as follows:

	2002	2001
(in thousands)		
Number of common shares	1,946	13,286
Gross proceeds	\$51,800	\$301,539
Less costs including underwriting fees	(1,880)	(14,651)
Net proceeds	<u>\$49,920</u>	<u>\$286,888</u>

In addition, the Company issued 204,855 shares of common stock with a value of \$5,157,000 to acquire one portfolio investment in a stock-for-stock exchange during 2001.

The Company has a dividend reinvestment plan, whereby the Company may buy shares of its common stock in the open market or issue new shares in order to satisfy dividend reinvestment requests. If the Company issues new shares, the issue price is equal to the average of the closing sale prices reported for the Company's common stock for the five consecutive days immediately prior to the dividend payment date.

Dividend reinvestment plan activity for the six months ended June 30, 2002 and for the year ended December 31, 2001 was as follows:

	2002	2001
(in thousands, except per share amounts)		
Shares issued	128	271
Average price per share	\$24.34	\$23.32

Note 7. Earnings Per Common Share

Earnings per common share for the three and six months ended June 30, 2002 and 2001 were as follows:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2002	2001	2002	2001
<i>(in thousands, except per share amounts)</i>				
Net increase in net assets resulting from operations	\$ 73,454	\$46,106	\$129,415	\$98,134
Less preferred stock dividends	(55)	(55)	(110)	(110)
Income available to common shareholders	\$ 73,399	\$46,051	\$129,305	\$98,024
Basic shares outstanding	101,660	89,356	100,822	87,441
Dilutive options outstanding to officers	1,780	1,492	2,078	1,525
Diluted shares outstanding	103,440	90,848	102,900	88,966
Basic earnings per common share	\$ 0.72	\$ 0.52	\$ 1.28	\$ 1.12
Diluted earnings per common share	\$ 0.71	\$ 0.51	\$ 1.26	\$ 1.10

Note 8. Dividends and Distributions

The Company's Board of Directors declared and the Company paid dividends of \$0.53 and \$0.55 per common share for the first and second quarters of 2002, respectively. The dividends totaled \$56,223,000 and \$109,482,000 for the three and six months ended June 30, 2002, respectively. The

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)****Note 8. Dividends and Distributions, continued**

Company's Board of Directors also declared a dividend of \$0.56 per common share for the third quarter of 2002.

Note 9. Supplemental Disclosure of Cash Flow Information

For the six months ended June 30, 2002 and 2001, the Company paid \$34,055,000, and \$31,916,000, respectively, for interest. For the six months ended June 30, 2002 and 2001, the Company's non-cash financing activities totaled \$5,498,000 and \$7,569,000, respectively, and

includes stock option exercises and dividend reinvestment.

Note 10. Hedging Activities

The Company invests in BB+, BB and BB- CMBS bonds, which are purchased at prices that are based on the 10-year Treasury rate. The Company has entered into transactions with two financial institutions to hedge against movement in Treasury rates on certain of these CMBS bonds. These transactions involved the Company receiving the proceeds from the sale of the borrowed Treasury securities, with the obligation to replenish the borrowed Treasury securities at a later date based on the then current market price. Borrowed Treasury securities as of June 30, 2002 and December 31, 2001 consisted of the following:

(in thousands) Description of Issue	June 30, 2002		December 31, 2001	
	Cost	Value	Cost	Value
10-year Treasury, due August 2011	\$ 2,074	\$ 2,008	\$19,175	\$17,989
10-year Treasury, due August 2011	1,010	1,040	5,693	5,656
10-year Treasury, due August 2011	7,585	7,917	23,636	23,618
5-year Treasury, due February 2006	5,590	5,746	—	—
10-year Treasury, due August 2011	19,404	19,903	—	—
10-year Treasury, due February 2012	2,624	2,665	—	—
10-year Treasury, due February 2012	25,351	26,445	—	—
10-year Treasury, due February 2012	18,990	19,065	—	—
	<u>\$82,628</u>	<u>\$84,789</u>	<u>\$48,504</u>	<u>\$47,263</u>

Obligations to replenish borrowed Treasury securities as of June 30, 2002 and December 31, 2001 were \$84,789,000 and \$47,263,000, respectively, and are recorded as other liabilities. As of June 30, 2002, the total obligations on the hedge had increased since the original sale date due to changes in the yield on the borrowed Treasury securities, resulting in unrealized depreciation on the obligations of \$2,161,000. The net proceeds related to the sales of the borrowed Treasury securities of \$82,628,000 and \$48,504,000 have been recorded as an other asset at June 30, 2002 and December 31, 2001, respectively.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Note 11. Financial Highlights

	At and for the Six Months Ended June 30,		At and for the Years Ended December 31,				
	2002(5)	2001(5)	2001	2000	1999	1998	1997
Per Common Share Data							
Net asset value, beginning of period	\$ 13.57	\$ 12.11	\$ 12.11	\$ 10.20	\$ 8.79	\$ 8.07	\$ 8.34
Net investment income before income tax benefit (expense) and net realized and unrealized gains(1)	0.94	0.92	1.92	1.53	1.18	1.06	0.94
Income tax benefit (expense)(1)	—	—	0.01	—	—	(0.01)	(0.03)
Net realized and unrealized gains(1)	0.32	0.18	0.23	0.41	0.46	0.45	0.36
Minority interests(1)	—	—	—	—	—	—	(0.03)
Net increase in net assets resulting from operations	1.26	1.10	2.16	1.94	1.64	1.50	1.24
Net decrease in net assets from shareholder distributions(2)	(1.08)	(0.99)	(2.01)	(1.82)	(1.60)	(1.43)	(1.71)
Net increase in net assets from capital share transactions	0.27	0.57	1.31	1.79	1.37	0.65	0.20
Net asset value, end of period	\$ 14.02	\$ 12.79	\$ 13.57	\$ 12.11	\$ 10.20	\$ 8.79	\$ 8.07
Market value, end of period	\$ 22.65	\$ 23.15	\$ 26.00	\$ 20.88	\$ 18.31	\$ 17.31	\$ 22.25
Total return	(9.18)%	15.56%	35.43%	25.47%	14.99%	(15.74)%	77.76%
Ratios and Supplemental Data (\$ and shares in thousands, except per share amounts)							
Ending net assets	\$1,434,453	\$1,171,661	\$1,352,123	\$1,029,692	\$667,513	\$491,358	\$420,060
Common shares outstanding at end of period(3)	102,296	91,578	99,607	85,057	65,414	55,919	52,047
Diluted weighted average shares outstanding	102,900	88,966	93,003	73,472	60,044	51,974	49,251
Employee and administrative expenses/ average net assets	1.74%	1.85%	3.80%	4.98%	6.25%	7.09%	4.66%
Total expenses/average net assets(4)	4.26%	4.79%	9.31%	11.88%	12.44%	11.86%	12.43%
Net investment income/ average net assets(4)	6.94%	7.54%	15.15%	13.55%	12.61%	12.72%	11.15%
Portfolio turnover rate	8.33%	6.27%	10.04%	28.92%	34.19%	63.53%	42.72%
Average debt outstanding	\$ 940,357	\$ 812,500	\$ 847,121	\$ 707,400	\$461,500	\$261,300	\$336,800
Average debt per share	\$ 9.14	\$ 9.13	\$ 9.11	\$ 9.63	\$ 7.60	\$ 5.03	\$ 6.84

average cost per share \$ 0.00 \$ 0.00 \$ 0.00 \$ 0.00 \$ 0.00 \$ 0.00 \$ 0.00 \$ 0.00 \$ 0.00 \$ 0.00

- (1) Based on diluted weighted average number of shares outstanding for the period.
- (2) For the year ended December 31, 1997, shareholder distributions include \$0.51 of merger-related dividends.
- (3) Excludes 234,977, 516,779 and 810,456 common shares held in the deferred compensation trust at or for the years ended December 31, 2000, 1999, and 1998, respectively.
- (4) For the purpose of calculating the ratios, total expenses and net investment income for the year ended December 31, 1997 exclude merger expenses of \$5,159,000.
- (5) The results for the six months ended June 30, 2002 and 2001, respectively, are not necessarily indicative of the operating results to be expected for the full year.

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Note 12. Litigation

As of August 13, 2002, the Company is aware of seven class action lawsuits that have been filed in the United States District Court for the Southern District of New York against it, certain of its directors and officers and its former independent auditors, Arthur Andersen LLP, with respect to alleged violations of the securities laws. All of the actions essentially duplicate one another, pleading essentially the same allegations. The complaints filed in the lawsuits allege violations of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder, specifically alleging, among other things, that the Company misstated the value of certain portfolio investments in its financial statements, which allegedly resulted in the purchase of its common stock by purported class members at artificially inflated prices. Several of the complaints also allege state law claims for common law fraud. The lawsuits seek compensatory and other damages, and costs and expenses associated with the litigation. The Company believes that each of the lawsuits is without merit, and it intends to defend each of these lawsuits vigorously. While the Company does not expect these matters to materially affect its financial condition or results of operations, there can be no assurance of any particular outcome.

The Company also is party to certain other lawsuits in the normal course of business. While the outcome of these legal proceedings cannot at this time be predicted with certainty, the Company does not expect that these proceedings will have a material effect upon its financial condition or results of operations.

Note 13. Subsequent Events

On July 1, 2002, the Company completed the sale of WyoTech Acquisition Corporation for approximately \$84.4 million in cash. The Company's total cash proceeds from the sale of WyoTech, including the repayment of debt and preferred stock and the sale of our 91% common

equity ownership, were approximately \$77.0 million, resulting in a realized gain of \$60.6 million in the third quarter of 2002 on the transaction. The sale of WyoTech is subject to post-closing working capital adjustments, if any, and customary indemnification provisions. Total interest and related portfolio income earned from WyoTech for the three months ended June 30, 2002 was \$1.8 million, which will no longer occur due to the sale of the investment on July 1, 2002.

On July 31, 2002, the Company completed the sale of \$82.7 million of CMBS, which resulted in a realized gain of approximately \$12 million. The bonds sold had an effective yield of 12%. Additionally, the Company reversed previously recorded net unrealized appreciation of approximately \$5 million related to these bonds.

Independent Accountants' Review Report

The Board of Directors and Shareholders
Allied Capital Corporation and Subsidiaries:

We have reviewed the accompanying consolidated balance sheet of Allied Capital Corporation and subsidiaries, including the consolidated statement of investments, as of June 30, 2002, and the related consolidated statements of operations for the three- and six-month periods ended June 30, 2002, changes in net assets and cash flows for the six-month period ended June 30, 2002, and financial highlights (included in Note 11) for the six-month period ended June 30, 2002. These consolidated financial statements and financial highlights are the responsibility of the Company's management.

We conducted our review in accordance with standards established by the American Institute of Certified Public Accountants. A review of interim financial information consists principally of applying analytical procedures to financial data and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with auditing standards generally accepted in the United States of America, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the consolidated financial statements and financial highlights referred to above for them to be in conformity with accounting principles generally accepted in the United States of America.

The consolidated balance sheet of Allied Capital Corporation and subsidiaries, including the statement of investments, as of December 31, 2001, and financial highlights (included in note 11) for the year then ended, were audited by other auditors whose report dated February 20, 2002 expressed an unqualified opinion on those statements.

/s/ KPMG LLP

Washington, D.C.

July 22, 2002, except as to notes 12 and 13 which are as of August 13, 2002 and July 31, 2002, respectively

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following analysis of the financial condition and results of operations of the Company should be read in conjunction with the Company's Consolidated Financial Statements and the Notes thereto included herein and in the Company's annual report on Form 10-K for the year ended December 31, 2001.

Financial or other information presented for private finance portfolio companies has been obtained from the portfolio company, and the financial information presented may represent unaudited, projected or pro forma financial information, and therefore may not be indicative of actual results. In addition, the private equity industry uses financial measures such as EBITDA or EBITDAM (Earnings Before Interest, Taxes, Depreciation, Amortization and, in some instances, Management fees) in order to assess a portfolio company's financial performance and to value a portfolio company. EBITDA and EBITDAM are not intended to represent cash flow from operations as defined by accounting principles generally accepted in the United States of America and such information should not be considered as an alternative to net income, cash flow from operations or any other measure of performance prescribed by accounting principles generally accepted in the United States of America.

OVERVIEW

We are a business development company that provides long-term debt and equity investment capital to support the expansion of companies in a variety of industries. Our lending and investment activity is generally focused in private finance and commercial real estate finance, primarily in non-investment grade commercial mortgage-backed securities, which we refer to as CMBS. Our private finance activity principally involves providing financing through privately negotiated long-term debt and equity investment capital. Our private financing is generally used to fund growth, buyouts, acquisitions, recapitalizations, note purchases, and bridge financings. We generally invest in private companies though, from time to time, we may invest in public companies that lack access to public capital or whose securities may not be marginable.

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Our portfolio composition at June 30, 2002 and December 31, 2001 was as follows:

	At June 30, 2002	At December 31, 2001
Private Finance	69%	68%
Commercial Real Estate Finance	31%	32%
Small Business Finance	—%	—%

Our earnings depend primarily on the level of interest and related portfolio income, fee income and net realized and unrealized gains or losses earned on our investment portfolio after deducting interest paid on borrowed capital and operating expenses. Interest income results from the stated interest rate earned on a loan and the amortization of loan origination points and discounts. The level of interest income is directly related to the balance of the interest-bearing investment portfolio multiplied by the weighted average yield. Our ability to generate interest income is dependent on economic, regulatory and competitive factors that influence new investment activity, the amount of loans for which interest is not accruing and our ability to secure debt and equity capital for our investment activities.

PORTFOLIO AND INVESTMENT ACTIVITY

Total portfolio investment activity and yields at and for the three and six months ended June 30, 2002 and 2001 and at and for the year ended December 31, 2001 were as follows:

	At and for the Three Months Ended June 30,		At and for the Six Months Ended June 30,		At and for the Year Ended December 31,
	2002	2001	2002	2001	2001
(\$ in millions)	(unaudited)		(unaudited)		
Portfolio at value	\$2,381.0	\$2,000.6	\$2,381.0	\$2,000.6	\$2,329.6
Investments funded	\$ 115.5	\$ 149.0	\$ 195.5	\$ 299.8	\$ 680.3
Change in accrued or reinvested interest and dividends	\$ 6.2	\$ 10.9	\$ 19.5	\$ 25.5	\$ 51.6
Repayments	\$ 36.0	\$ 12.2	\$ 67.0	\$ 42.5	\$ 74.5
Sales	\$ 1.2	\$ 39.4	\$ 126.3	\$ 74.6	\$ 130.0
Yield*	13.8%	14.2%	13.8%	14.2%	14.3%

* The weighted average yield on the interest-bearing investments is computed as the (a) annual stated interest rate earned plus the annual amortization of loan origination fees, original issue discount and market discount earned on accruing interest-bearing investments, divided by (b) total interest-bearing investments at value. The weighted average yield is computed as of the balance sheet date.

Private Finance

The private finance portfolio, investment activity and yields at and for the three and six months ended June 30, 2002 and 2001 and at and for the year ended December 31, 2001 were as follows:

(\$ in millions)	At and for the Three Months Ended June 30,		At and for the Six Months Ended June 30,		At and for the Year Ended December 31,
	2002	2001	2002	2001	2001
	(unaudited)		(unaudited)		
Portfolio at value:					
Loans and debt securities	\$1,050.8	\$1,044.5	\$1,050.8	\$1,044.5	\$1,107.9
Equity interests	584.5	360.9	584.5	360.9	487.2
Total portfolio	<u>\$1,635.3</u>	<u>\$1,405.4</u>	<u>\$1,635.3</u>	<u>\$1,405.4</u>	<u>\$1,595.1</u>
Investments funded	\$ 32.2	\$ 93.3	\$ 69.8	\$ 113.9	\$ 287.7
Change in accrued or reinvested interest and dividends	\$ 7.0	\$ 12.2	\$ 19.1	\$ 24.4	\$ 48.9
Repayments	\$ 27.2	\$ 6.1	\$ 56.0	\$ 23.1	\$ 43.8
Yield*	13.9%	14.6%	13.9%	14.6%	14.8%

* The weighted average yield on loans and debt securities is computed as the (a) annual stated interest rate earned plus the annual amortization of loan origination fees, original issue discount and market discount earned on accruing loans and debt securities, divided by (b) total loans and debt securities at value. The weighted average yield is computed as of the balance sheet date.

Private finance new investment activity across the industry slowed during 2001, largely due to a lack of available senior debt capital and the state of the economy in general. We believe the level of merger and acquisition activity throughout the U.S. has continued to be depressed into 2002, and we have seen fewer opportunities for mezzanine or equity investment in the first six months of 2002 as compared to 2001. We believe the environment for private finance investing appears to be improving and, although the merger and acquisition environment remains slow, we are seeing more new investment opportunities related to recapitalization and growth financings. In the third quarter of 2002, we have completed two financings totaling \$51 million to date. We are also beginning to see increasing activity within our own portfolio as there are several companies in the private finance portfolio that are in the process of exploring sale, initial public offering or recapitalization events. This means that we may see opportunities to continue our involvement with some of these companies by financing the buyout or recapitalization transactions. This activity could also result in additional potential realized or unrealized gains for the remainder of 2002 and into 2003.

Investments funded during the three and six month periods ended June 30, 2002 and the year ended December 31, 2001 consisted of the following:

(\$ in thousands)	Loans and Debt Securities	Equity Interests	Total
<i>For the three months ended June 30, 2002(1)</i>			
Companies more than 25% owned	\$ 12,550	\$ 3,378	\$ 15,928
Companies 5% to 25% owned	5,400	7,000	12,400
Companies less than 5% owned	3,359	463	3,822
Total	<u>\$ 21,309</u>	<u>\$10,841</u>	<u>\$ 32,150</u>

<i>For the six months ended June 30, 2002(1)</i>			
Companies more than 25% owned	\$ 15,962	\$ 3,759	\$ 19,721
Companies 5% to 25% owned	7,494	7,046	14,540
Companies less than 5% owned	34,023	1,506	35,529
Total	\$ 57,479	\$12,311	\$ 69,790
<i>For the year ended December 31, 2001(1)</i>			
Companies more than 25% owned	\$ 47,860	\$78,260	\$126,120
Companies 5% to 25% owned	8,203	3,721	11,924
Companies less than 5% owned	142,144	7,548	149,692
Total	\$198,207	\$89,529	\$287,736

(1) The private finance portfolio is presented in three categories—companies more than 25% owned which represent portfolio companies where we directly or indirectly own more than 25% of the outstanding voting securities of such portfolio company and therefore are deemed controlled by us under the 1940 Act; companies owned 5% to 25% which represent portfolio companies where we directly or indirectly own 5% to 25% of the outstanding voting securities of such portfolio company or where we hold one or more seats on the portfolio company's board of directors and, therefore are deemed to be an affiliated person under the 1940 Act; and companies less than 5% owned which represent portfolio companies where we directly or indirectly own less than 5% of the outstanding voting securities of such portfolio company and where we have no other affiliations with such portfolio company.

At June 30, 2002, we had outstanding funding commitments of \$69.0 million to portfolio companies, including \$31.6 million committed to private venture capital funds.

We fund new investments using cash, through the issuance of our common equity, the reinvestment of previously accrued interest and dividends in debt or equity securities, or the current reinvestment of interest and dividend income through the receipt of a debt or equity security (payment-in-kind income). From time to time we may opt to reinvest accrued interest receivable in a new debt or equity security, in lieu of receiving such interest in cash and providing a subsequent growth investment.

We may acquire more than 50% of the common stock of a company in a control buyout transaction. Control investments are generally structured such that we earn a current return through a combination of interest income on our senior loans and subordinated debt, dividends on our preferred and common stock, and management or transaction services fees to compensate us for the managerial assistance that we provide to a controlled portfolio company. In some cases for companies that are more than 50% owned, we may not accrue interest on loans and debt securities if such company is in need of additional capital and, therefore, we may defer current debt service. Our most significant investments acquired through control buyout transactions at June 30, 2002 were The Hillman Companies, Inc., (formerly SunSource, Inc.), acquired in 2001, Business Loan Express, Inc., acquired in 2000 and WyoTech Acquisition Corporation, acquired in 1998.

The Hillman Companies, Inc. During 2001, we acquired 93.2% of the common equity of SunSource, Inc. for \$71.5 million in cash. Subsequently, SunSource completed the sale of its STS business unit and distributed \$16.5 million in cash to us, reducing our common stock cost basis to

\$57.2 million at December 31, 2001. As part of the STS sale, we invested \$3.2 million in the new STS. During the third quarter of 2001, we received fees from SunSource of \$2.8 million related to transaction assistance for the SunSource sale and STS sale, and \$1.6 million for the syndication of SunSource's senior credit facilities. In addition, we realized a gain of \$2.5 million from the sale of warrants prior to the buyout transaction. During the first quarter of 2002, SunSource changed its name to The Hillman Companies, Inc., also referred to as Hillman. At June 30, 2002, our investment in Hillman totaled \$131.0 million at value, or 5% of total assets. The value of our investment in Hillman increased by \$32.8 million during the second quarter of 2002 as discussed below.

Hillman is a leading manufacturer of key making equipment and distributor of key blanks, fasteners, signage and other small hardware components and operates in multiple channels of the retail marketplace such as hardware stores, national and regional home centers and mass merchants. Hillman has certain patent-protected products including key duplication technology that is important to its business. Hillman's primary operations are located in Cincinnati, Ohio.

For the six months ended June 30, 2002, Hillman had total revenue of \$139 million, earnings before interest, taxes, depreciation, amortization and management fees, or EBITDAM, of \$23 million, and profits before taxes of \$3 million. Hillman is above plan for the year and as of June 30, 2002, is projected to achieve revenues of approximately \$276 million, EBITDAM of approximately \$50 million, and profits before taxes of approximately \$7 million for the year ending December 31, 2002. Hillman had total assets of \$360 million and total debt of \$141 million at June 30, 2002. Hillman is current on all of its debt obligations and is in compliance with all debt covenants.

Business Loan Express, Inc. On December 31, 2000, we acquired 94.9% of BLC Financial Services, Inc. in a "going private" buyout transaction for \$95.2 million. We issued approximately 4.1 million shares of our common stock, or \$86.1 million of new equity, and paid \$9.1 million in cash to acquire BLC, which thereafter changed its name to Business Loan Express, Inc.

As part of the transaction, we recapitalized Allied Capital Express, our small business lending operation, as an independently managed private portfolio company and merged it into Business Loan Express. We contributed certain assets, including our online rules-based underwriting technology and fixed assets, and transferred 37 employees to the private portfolio company. Upon completion of the transaction, our investment in Business Loan Express as of December 31, 2000 totaled \$204.1 million and consisted of \$74.5 million of subordinated debt, \$25.1 million of preferred stock, and \$104.5 million of common stock. At June 30, 2002, our investment in Business Loan Express totaled \$251.9 million at value, or 9.8% of our total assets. During the second quarter of 2002, the value of our investment in Business Loan Express increased by \$19.9 million, and as of June 30, 2002, we have recorded total unrealized appreciation of \$35.4 million on this investment.

Business Loan Express is the nation's second largest non-bank government guaranteed lender utilizing the Small Business Administration's 7(a) Guaranteed Loan Program and is licensed by the Small Business Administration as a Small Business Lending Company (SBLC). Therefore, changes in the laws or regulations that govern SBLCs or the Small Business Administration's 7(a) Guaranteed Loan Program or changes in government

funding for this program could have a material impact on Business Loan Express or its operations. Business Loan Express is a preferred lender as designated by the Small Business Administration in 67 markets across the United States, and originates, sells and services small business loans. In addition to the 7(a) Guaranteed Loan Program, Business Loan Express originates loans under the USDA Business and Industry Guaranteed Loan Program and originates conventional small business loans. Business Loan Express has offices in 35 cities and is headquartered in New York, New York.

Unaudited financial data for Business Loan Express at and for the year ended June 30, 2002 was as follows:

	At and for the Year Ended June 30, 2002(1) (unaudited)
(\$ in millions)	
Operating Data	
Total revenue	\$ 84.6
Profits before taxes	\$ 3.6
Earnings before interest, taxes and management fees (EBITM)	\$ 43.0
Balance Sheet Data	
Total assets(2)	\$ 276.2
Total debt	\$ 183.0
Total shareholders' equity	\$ 59.0
Other Data	
Total loan originations	\$ 565.1
Serviced loan portfolio	\$1,372.6
Number of loans	2,083
Loan delinquencies(3)	9.4%

- (1) Financial results at and for the year ended June 30, 2002 are preliminary and not audited and are therefore subject to adjustment prior to completion of the audit.
- (2) Included in total assets is \$6 million of goodwill. There is no other goodwill on BLX's balance sheet. We acquired 94.9% of BLC Financial Services, Inc. on December 31, 2000. "Push-down" accounting was not required with respect to this transaction; accordingly, goodwill was not recorded by BLX.
- (3) Represents the percentage of loans in the serviced portfolio that are greater than 30 days delinquent, which includes loans in workout status. Delinquencies for the types of small business loans made by BLX typically range between 8% and 12%.

The loans originated by Business Loan Express, or BLX, are generally secured by commercial real estate. Loans originated under the 7(a) Guaranteed Loan Program also require the personal guarantee of the borrower and, in many cases, the loans are also secured by additional real estate collateral. Because the loans are secured by collateral, Business Loan Express' annual loan losses for its SBA 7(a) loans, computed using the unguaranteed balance of the SBA 7(a) serviced portfolio, were 0.6% on average for the last five years.

Business Loan Express sells or securitizes substantially all of the loans it originates. BLX currently sells the guaranteed piece of SBA 7(a) guaranteed loans for cash premiums of up to 10% of the guaranteed loan amount plus a retained annual servicing fee

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generally between 1% and 1.6% of the guaranteed loan amount. Alternatively, BLX may sell the guaranteed piece of SBA 7(a) guaranteed loans at par and retain an annual servicing spread, at current prices, of generally between 4.0% and 4.8%. BLX securitizes the unguaranteed piece of the SBA 7(a) loans and other loans it originates. Typically, BLX retains between 0% and 2.7% of the loan securitization pools and receives a spread from the excess of loan interest received on the loans sold over the interest cost on the securities issued in the securitization generally between 4.7% and 4.8%.

As a result of BLX's guaranteed loan sales and as a result of securitization transactions, BLX had assets at June 30, 2002 totaling approximately \$106 million representing the residual interests in and servicing assets for loans sold or securitized, together referred to as Residual Interests. These Residual Interests represent the discounted present value of future cash flow streams to be received from loans sold or securitized after making allowances for prepayments, losses and loan delinquencies.

If loan payments on all loans were to be received as stated in the loan agreements, estimated future cash flows to BLX from loans sold or securitized would total approximately \$412 million in the aggregate over the remaining term of these loans. Of the approximate \$412 million, estimated cash flows for the years ended June 30, 2003, 2004, 2005, and 2006 would be approximately \$33 million, \$31 million, \$30 million and \$29 million, respectively.

Business Loan Express has a three-year \$124 million revolving credit facility. As the controlling shareholder of Business Loan Express, we have provided an unconditional guaranty to the revolving credit facility lenders in an amount of up to 50% of the total obligations (consisting of principal, accrued interest and other fees) of Business Loan Express under the revolving credit facility. The amount guaranteed by us at June 30, 2002 was \$48.1 million. This guaranty can be called by the lenders only in the event of a default by Business Loan Express. Business Loan Express was in compliance with the terms of the revolving credit facility at June 30, 2002. We have also provided two standby letters of credit in connection with two term securitization transactions completed by Business Loan Express in the second quarter of 2002 totaling \$10.6 million.

Business Loan Express is currently contemplating a corporate restructure and recapitalization whereby the company would convert from a corporation to a limited liability company. This restructure would enable the company to have greater flexibility as it grows. Upon such restructure and recapitalization our equity interests would be converted to membership units and the earnings of Business Loan Express would pass through to its members as dividends. There can be no assurance when or if the corporate restructure and recapitalization will occur.

WyoTech Acquisition Corporation. On July 1, 2002, we sold WyoTech Acquisition

Corporation for \$84.4 million in cash. We acquired WyoTech in December of 1998 and owned 91% of the common equity of WyoTech. At June 30, 2002, our investment had a cost basis of \$16.4 million, which represented all of the debt (\$12.6 million), preferred stock (\$3.7 million) and 91% of the common equity capital (\$0.1 million) of WyoTech. Our total cash proceeds from the sale of WyoTech, including the repayment of debt and preferred stock and the sale of our 91% common equity ownership, were approximately \$77.0 million, resulting in a realized gain of approximately \$60.6 million on the transaction. At June 30, 2002, we determined the fair value of our investment in WyoTech to be \$77.0 million, which resulted in an increase in fair value during the second quarter of

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\$6.6 million. The sale of WyoTech is subject to post-closing working capital adjustments, if any, and customary indemnification provisions.

Commercial Real Estate Finance

The commercial real estate finance portfolio, investment activity and yields at and for the three and six months ended June 30, 2002 and 2001 and at and for the year ended December 31, 2001 were as follows:

(\$ in millions)	At and for the Three Months Ended June 30,		At and for the Six Months Ended June 30,		At and for the Year Ended December 31,
	2002	2001	2002	2001	2001
	(unaudited)		(unaudited)		
Portfolio at value:					
CMBS bonds	\$560.9	\$405.5	\$560.9	\$405.5	\$558.3
Collateralized debt obligations	52.5	24.9	52.5	24.9	24.2
Total CMBS	613.4	430.4	613.4	430.4	582.5
Commercial mortgage loans	62.0	87.8	62.0	87.8	79.6
Residual interest	69.0	74.9	69.0	74.9	69.9
Real estate owned	1.3	2.1	1.3	2.1	2.5
Total Portfolio	\$745.7	\$595.2	\$745.7	\$595.2	\$734.5
Investments funded	\$ 83.3	\$ 55.7	\$125.7	\$185.9	\$392.6
Change in accrued or reinvested interest	\$ (0.8)	\$ (1.3)	\$ 0.4	\$ 1.1	\$ 2.7
Repayments	\$ 8.8	\$ 6.1	\$ 11.0	\$ 19.4	\$ 30.7
Sales	\$ 1.2	\$ 39.4	\$126.3	\$ 74.6	\$130.0
Yield*	13.7%	13.6%	13.7%	13.6%	13.5%

* The weighted average yield on the interest-bearing investments is computed as the (a) annual stated interest rate earned plus the annual amortization of loan origination fees, original issue discount and market discount earned on accruing interest-bearing investments, divided by (b) total interest-bearing investments at value. The weighted average yield is computed as of the balance sheet date. Interest-bearing investments for the commercial real estate finance portfolio include all investments except for real estate owned.

Our primary commercial real estate investment activity is the investment in non-investment

grade commercial mortgage-backed securities, or CMBS. In 1998, we began to take advantage of a unique market opportunity to acquire non-investment grade CMBS bonds at significant discounts from the face amount of the bonds. We believe that CMBS is an attractive asset class because of the yields that can be earned on a security that is secured by commercial mortgage loans, and ultimately commercial real estate properties. We plan to continue our CMBS investment activity, however, in order to maintain a balanced portfolio, we expect that CMBS will continue to represent approximately 20% to 25% of our total assets. Our CMBS investment activity level will be dependent upon our ability to invest in CMBS at attractive yields.

Our commercial real estate investment activity for the three and six months ended June 30, 2002 and for the year ended December 31, 2001 was as follows:

	Amount Invested			Yield(1)
	Face Amount	Discount	Amount Funded	
(\$ in millions)				
<i>For the three months ended June 30, 2002</i>				
CMBS bonds	\$143.3	\$(65.0)	\$78.3	13.9%
CDOs	4.9	—	4.9	16.6%
Commercial mortgage loans	0.1	—	0.1	10.0%
Total	\$148.3	\$(65.0)	\$83.3	14.0%

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	Amount Invested			Yield(1)
	Face Amount	Discount	Amount Funded	
(\$ in millions)				
<i>For the six months ended June 30, 2002</i>				
CMBS bonds	\$181.4	\$ (83.8)	\$ 97.6	14.7%
CDOs	28.0	—	28.0	17.5%
Commercial mortgage loans	0.1	—	0.1	10.0%
Total	<u>\$209.5</u>	<u>\$ (83.8)</u>	<u>\$125.7</u>	15.2%
<i>For the year ended December 31, 2001</i>				
CMBS bonds	\$661.4	\$(295.6)	\$365.8	14.0%
CDOs	24.6	—	24.6	16.9%
Commercial mortgage loans	2.2	—	2.2	10.0%
Total	<u>\$688.2</u>	<u>\$(295.6)</u>	<u>\$392.6</u>	14.2%

(1) The yield on new CMBS bond investments will vary from period to period depending on the concentration of lower yielding BB+, BB and BB- CMBS bonds purchased in that period to the total amount invested.

CMBS Bonds. The non-investment grade and unrated tranches of the CMBS bonds in which we invest are junior in priority for payment of interest and principal to the more senior tranches of the related CMBS bond issuance. Cash flow from the underlying mortgages generally is allocated first

to the senior tranches, with the most senior tranches having a priority right to the cash flow. Then, any remaining cash flow is allocated, generally, among the other tranches in order of their relative seniority. To the extent there are defaults and unrecoverable losses on the underlying mortgages resulting in reduced cash flows, our most subordinate tranche will bear this loss first. At June 30, 2002, our CMBS bonds were subordinate to 92% to 97% of the tranches of bonds issued in various CMBS transactions. Given that the non-investment grade CMBS bonds in which we invest are junior in priority for payment of principal, we invest in these CMBS bonds at an approximate discount of 50% from the face amount of the bonds.

The underlying pools of mortgage loans that are collateral for our new CMBS bond investments for the six months ended June 30, 2002 and for the year ended December 31, 2001 had respective underwritten loan to value and underwritten debt service coverage ratios as follows:

Loan to Value Ranges (\$ in millions)	For the Six Months Ended June 30,		For the Year Ended December 31,	
	2002		2001	
	Amount	Percentage	Amount	Percentage
Less than 60%	\$ 401.9	16%	\$1,259.7	15%
60-65%	178.7	7	941.6	11
65-70%	264.1	11	1,140.6	14
70-75%	799.5	32	2,400.4	29
75-80%	812.7	33	2,466.4	30
Greater than 80%	12.0	1	119.6	1
Total	\$2,468.9	100%	\$8,328.3	100%
Weighted average loan to value	70.4%		69.7%	

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Debt Service Coverage Ratio(1) Ranges (\$ in millions)	For the Six Months Ended June 30,		For the Year Ended December 31,	
	2002		2001	
	Amount	Percentage	Amount	Percentage
Greater than 2.00	\$ 103.3	4%	\$ 484.8	6%
1.76-2.00	84.2	3	158.2	2
1.51-1.75	240.3	10	855.0	10
1.26-1.50	1,631.8	66	5,008.3	60
1.00-1.25	409.3	17	1,822.0	22
Total	\$2,468.9	100%	\$8,328.3	100%
Weighted average debt service coverage ratio	1.41		1.48	

(1) Defined as annual net cash flow before debt service divided by annual debt service payments.

As a part of our strategy to maximize our return on equity capital, we sold CMBS bonds rated

BB+, BB and BB- during the six months ended June 30, 2002, and during 2001 totaling \$123.3 million and \$124.5 million, respectively. These bonds had an effective yield of 11.2% and 10.3%, and were sold for \$128.8 million and \$126.8 million, respectively, resulting in realized gains on the sales. The sales of these lower-yielding bonds increased our overall liquidity. We did not sell any CMBS bonds during the second quarter of 2002.

The effective yield on our CMBS portfolio at June 30, 2002 and December 31, 2001 was 14.6% and 14.7%, respectively. The yield on the CMBS portfolio at any point in time will vary depending on the concentration of lower yielding BB+, BB and BB- CMBS bonds held in the portfolio. At June 30, 2002 and December 31, 2001, the unamortized discount related to the CMBS portfolio was \$645.0 million and \$611.9 million, respectively. At June 30, 2002, the CMBS bond portfolio had a fair value of \$560.9 million, which included net unrealized appreciation on the CMBS bonds of \$23.9 million.

At June 30, 2002, the underlying pools of mortgage loans that are collateral for our CMBS bonds consisted of approximately 4,100 commercial mortgage loans with a total outstanding principal balance of \$22.9 billion. At June 30, 2002 and December 31, 2001, 0.75% and 0.52%, respectively, of the loans in the underlying collateral pool for our CMBS bonds were over 30 days delinquent or were classified as real estate owned.

On July 31, 2002, we sold \$129.8 million of face amount of CMBS bonds, with a cost basis of \$82.7 million, and recognized a gain on the sale of approximately \$12 million. The CMBS bonds sold represent a strip of BB+ through B from our portfolio and had a weighted average yield to maturity of 12%. The CMBS bonds were sold to institutional investors. We had recorded approximately \$5 million in net unrealized appreciation, which is net of unrealized depreciation on the related hedge of approximately \$1 million, related to these CMBS bonds in the second quarter of 2002. Therefore, this sale will contribute earnings of approximately \$7 million to the third quarter of 2002. Upon completion of the CMBS bond sale, we continue to own \$471.3 million of non-investment grade CMBS bonds at value with a yield to maturity of 15.2%.

Collateralized Debt Obligations. During the six months ended June 30, 2002, and the year ended December 31, 2001, we invested in the preferred shares of two and one, respectively, collateralized debt obligations, or CDOs, which are secured by investment grade unsecured debt issued by various real estate investment trusts, or REITs, and investment and non-investment grade CMBS bonds. The investment grade REIT debt

collateral consists of \$852.8 million issued by 39 REITs. The investment grade CMBS collateral consists of CMBS bonds with a face amount of \$402.1 million issued in 26 separate CMBS transactions. The non-investment grade CMBS collateral consists of BB+, BB and BB- CMBS bonds with a face amount of \$405.0 million that were issued in 30 separate CMBS transactions. Included in the CMBS collateral for the CDOs are \$393.8 million of CMBS bonds that are senior in priority of repayment to certain lower rated CMBS bonds held by us, which were issued in 22 separate CMBS transactions. The preferred shares are junior in priority for payment of principal to the more senior tranches of debt issued by the CDOs. To the extent there are defaults and

unrecoverable losses on the underlying collateral resulting in reduced cash flows, the preferred shares will bear this loss first. At June 30, 2002, our preferred shares in the CDOs were subordinate to approximately 95% of the more senior tranches of debt issued by the CDOs. The yield on the CDOs was 17.2% and 16.9% at June 30, 2002, and December 31, 2001, respectively.

Commercial Mortgage Loans. We have been liquidating much of our whole commercial mortgage loan portfolio so that we can redeploy the proceeds into higher yielding assets. For the three and six months ended June 30, 2002, and for the year ended December 31, 2001, we sold \$1.2 million, \$3.0 million and \$5.5 million, respectively, of commercial mortgage loans. At June 30, 2002, our whole commercial real estate loan portfolio had been reduced to \$62.0 million from \$79.6 million at December 31, 2001.

Residual Interests. The residual interest primarily consists of a retained interest totaling \$68.9 million from a 1998 asset securitization whereby bonds were sold in three classes rated AAA, AA and A. The residual interest represents a right to cash flows from the underlying collateral pool of loans after these senior bond obligations are satisfied. At June 30, 2002, two classes of bonds rated AAA and AA+ are outstanding, for total bonds outstanding of \$29.6 million. On August 9, 2002, the bonds rated AA+ were upgraded to AAA. We have the right to call the bonds when the outstanding bond balance is less than \$23.9 million. Once the bonds are fully repaid, either through the cash flows from the securitized loans or due to us calling the bonds, the remaining loans in the trust will be returned to us as payment on the residual interest. At June 30, 2002, the residual interest had a fair value of \$69.0 million.

Portfolio Asset Quality

We employ a standard grading system for the entire portfolio. Grade 1 is used for those investments from which a capital gain is expected. Grade 2 is used for investments performing in accordance with plan. Grade 3 is used for investments that require closer monitoring; however, no loss of interest or principal is expected. Grade 4 is used for investments that are in workout and for which some loss of current interest is expected, but no loss of principal is expected. Grade 5 is used for investments that are in workout and for which some loss of principal is expected and the investment is written down to net realizable value.

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At June 30, 2002 and December 31, 2001, our portfolio was graded as follows:

Grade (\$ in millions)	2002		2001	
	Portfolio at Value	Percentage of Total Portfolio	Portfolio at Value	Percentage of Total Portfolio
1	\$ 793.6	33.3%	\$ 603.3	25.9%
2	1,400.0	58.8	1,553.8	66.7
3	46.7	2.0	79.5	3.4
4	43.6	1.8	44.5	1.9
5	97.1	4.1	48.5	2.1

<u>\$2,381.0</u>	<u>100.0%</u>	<u>\$2,329.6</u>	<u>100.0%</u>
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Total Grades 4 and 5 assets as a percentage of the total portfolio at value at June 30, 2002 and December 31, 2001 were 5.9% and 4.0%, respectively. We expect that a number of portfolio companies will be in the Grades 4 or 5 categories from time to time. Part of the business of private finance is working with troubled portfolio companies to improve their businesses and protect our investment. The number of portfolio companies and related investment amount included in Grades 4 and 5 may fluctuate significantly from period to period. We continue to follow our historical practice of working with a troubled portfolio company in order to recover the maximum amount of our investment, but record unrealized depreciation for the expected full amount of the potential loss when such exposure is identified.

For the total investment portfolio, workout loans not accruing interest, or those loans in Grade 4 and 5, were \$121.4 million at value at June 30, 2002, or 5.1% of the total portfolio. Included in this category at June 30, 2002, were assets valued at \$8.9 million that represent receivables related to companies in liquidation and loans of \$16.2 million that were secured by commercial real estate. Workout loans not accruing interest were \$109.0 million at value at December 31, 2001 or 4.7% of the total portfolio of which \$8.9 million represented receivables related to companies in liquidation, and \$15.2 million represented loans secured by commercial real estate. In addition to Grade 4 and 5 assets that are in workout, we may not accrue interest on loans to companies which are more than 50% owned by us from time to time if such companies are in need of additional capital and, therefore, we may defer current debt service. Loans and debt securities to such companies totaled \$61.3 million at value at June 30, 2002. Loans greater than 90 days delinquent were \$89.4 million at value at June 30, 2002, or 3.8% of the total portfolio. Included in this category are loans valued at \$22.0 million that are secured by commercial real estate. Loans greater than 90 days delinquent were \$39.1 million at value at December 31, 2001 or 1.7% of the total portfolio. Included in this category are loans valued at \$14.1 million that were secured by commercial real estate.

As a provider of long-term privately negotiated investment capital, we may defer payment of principal or interest from time to time. As a result, the amount of the portfolio that is greater than 90 days delinquent or on non-accrual status may vary from quarter to quarter. The nature of our private finance portfolio company relationships frequently provide an opportunity for portfolio companies to amend the terms of payment to us or to restructure their debt and equity capital. During such restructuring, we may not receive or accrue interest or dividend payments. The investment portfolio is priced to provide current

returns for shareholders assuming that a portion of the portfolio at any time may not be accruing interest currently. We also price our investments for a total return including interest or dividends plus capital gains from the sale of equity securities. Therefore, the amount of loans greater than 90 days delinquent or on non-accrual status is not necessarily an indication of future principal loss or loss of anticipated investment return. Our portfolio grading system is used as a means to assess loss of investment principal (Grade 5 assets).

At June 30, 2002 and December 31, 2001, 0.75% and 0.52% of the loans in the underlying

collateral pool for our CMBS bond portfolio were over 30 days delinquent or were classified as real estate owned. We closely monitor the performance of all of the loans in the underlying collateral pools securing our CMBS investments.

Other Assets and Other Liabilities

Because we invest in BB+, BB and BB- rated CMBS bonds, which are purchased at prices that are based on the 10-year Treasury rate, we have entered into transactions with financial institutions to hedge against movement in Treasury rates on certain of these CMBS bonds. These transactions involved receiving the proceeds from the sales of the borrowed Treasury securities, with the obligations to replenish the borrowed Treasury securities at a later date based on the then current market price.

The total obligations to replenish borrowed Treasury securities were \$84.8 million and \$47.3 million at June 30, 2002 and December 31, 2001, respectively, which included unrealized depreciation on the obligations of \$2.2 million and unrealized appreciation on the obligations of \$1.2 million, respectively, due to changes in the yield on the borrowed Treasury securities. The obligations have been recorded as an other liability. The proceeds related to the sales of the borrowed Treasury securities were \$82.6 million and \$48.5 million at June 30, 2002 and December 31, 2001, respectively, and have been recorded as an other asset.

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RESULTS OF OPERATIONS

Comparison of Three Months Ended June 30, 2002 and 2001

The following table summarizes our condensed operating results for the three months ended June 30, 2002 and 2001.

	For the Three Months Ended June 30,			Percent Change
	2002	2001	Change	
(\$ in thousands, except per share amounts)				
	(unaudited)			
Interest and Related Portfolio Income				
Interest and dividends	\$ 62,692	\$58,824	\$ 3,868	7%
Premiums from loan dispositions	46	910	(864)	(95%)
Fees and other income	10,455	9,005	1,450	16%
Total interest and related portfolio income	73,193	68,739	4,454	6%
Expenses				
Interest	17,515	15,951	1,564	10%
Employee	8,274	7,610	664	9%
Administrative	4,843	3,060	1,783	58%
Total operating expenses	30,632	26,621	4,011	15%

Net investment income before net realized and unrealized gains	42,561	42,118	443	1%
Net Realized and Unrealized Gains				
Net realized gains (losses)	(755)	3,837	(4,592)	*
Net unrealized gains	31,648	151	31,497	*
Total net realized and unrealized gains	30,893	3,988	26,905	*
Net increase in net assets resulting from operations	\$ 73,454	\$46,106	\$27,348	59%
Diluted earnings per share	\$ 0.71	\$ 0.51	\$ 0.20	39%
Weighted average shares outstanding — diluted	103,440	90,848	12,592	14%

* Net realized and net unrealized gains and losses can fluctuate significantly from quarter to quarter. As a result, quarterly comparisons of net realized and net unrealized gains and losses may not be meaningful.

Net increase in net assets resulting from operations, or net income, results from total interest and related portfolio income earned, less total expenses incurred in our operations, plus net realized and unrealized gains or losses.

Total Interest and Related Portfolio Income. Total interest and related portfolio income includes interest income, premiums from loan dispositions and fees and other income.

	For the Three Months Ended June 30,	
	2002	2001
(\$ in millions, except per share amounts)		
Total Interest and Related Portfolio Income	\$73.2	\$68.7
Per share	\$0.71	\$0.76

The increase in interest income earned results primarily from the growth of our investment portfolio. Our investment portfolio, excluding non-interest bearing equity

interests in portfolio companies, increased by 10% to \$1,796.5 million at June 30, 2002 from \$1,639.7 million at June 30, 2001. The weighted average yield on the interest-bearing investments in the portfolio at June 30, 2002 and 2001 was as follows:

	June 30,	
	2002	2001
Private Finance	13.9%	14.6%
Commercial Real Estate Finance	13.7%	13.6%
Total Portfolio	13.8%	14.2%

Included in premiums from loan dispositions are prepayment premiums of \$0 and \$0.1 million for the three months ended June 30, 2002 and 2001, respectively. While the scheduled maturities of private finance and commercial real estate loans range from five to ten years, it is not unusual for

our borrowers to refinance or pay off their debts to us ahead of schedule. Because we seek to finance primarily seasoned, performing companies, such companies at times can secure lower cost financing as their balance sheets strengthen, or as more favorable interest rates become available. Therefore, we generally structure our loans to require a prepayment premium for the first three to five years of the loan.

Fees and other income primarily include fees related to financial structuring, diligence, management services to portfolio companies, guaranties and other advisory services. We generate fee income for the transaction services and management services that we provide. As a business development company, we are required to make significant managerial assistance available to the companies in our investment portfolio. Managerial assistance includes management and consulting services including, but not limited to, information technology, web site development, marketing, human resources, personnel recruiting, board recruiting, corporate governance and risk management.

Fees and other income for the quarter ended June 30, 2002 included fees of \$2.6 million related to structuring and diligence, fees of \$1.8 million related to transaction services provided to portfolio companies, and fees of \$6.0 million related to management services provided to portfolio companies, guaranty and other advisory services. Fees and other income are generally related to specific transactions or services, and therefore may vary substantially from period to period. Points or loan origination fees that represent yield enhancement on a loan are capitalized and amortized into interest income over the life of the loan.

Business Loan Express, Hillman and WyoTech are our most significant portfolio investments and together represent 17.9% of our total assets at June 30, 2002. Total interest and related portfolio income earned from these investments for the three months ended June 30, 2002 and 2001 was \$14.0 million and \$10.2 million, respectively. Total interest and related portfolio income earned from WyoTech for the three months ended June 30, 2002 was \$1.8 million, which will no longer occur due to the sale of the investment on July 1, 2002.

Operating Expenses. Operating expenses include interest, employee and administrative expenses. Our single largest expense is interest on our indebtedness. The fluctuations in interest expense during the three months ended June 30, 2002 and 2001 are attributable to changes in the level of our borrowings under various notes payable and debentures and

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our revolving credit facility. Our borrowing activity and weighted average interest cost, including fees and closing costs, were as follows:

	At and for the Three Months Ended June 30,	
	2002	2001
(\$ in millions)		
Total Outstanding Debt	\$1,009.0	\$881.1
Average Outstanding Debt	\$ 942.3	\$812.5

Weighted Average Cost	7.2%	7.4%
BDC Asset Coverage*	256%	247%

* As a business development company, we are generally required to maintain a minimum ratio of 200% of total assets to total borrowings.

Employee expenses include salaries and employee benefits. The increase in salaries and employee benefits for the periods presented reflects wage increases and the experience level of employees hired. Total employees were 103 and 101 at June 30, 2002 and 2001, respectively.

Administrative expenses include the leases for our headquarters in Washington, DC, and our regional offices, travel costs, stock record expenses, directors' fees, legal and accounting fees, insurance premiums and various other expenses. The increase in administrative expenses as compared to the same period in 2001 includes approximately \$1.2 million from legal, consulting and other fees, including costs incurred to defend against class action lawsuits alleging violations of securities laws and to respond to market activity in our stock. Administrative expenses also increased by approximately \$0.1 million due to increased costs for corporate liability insurance, \$0.3 million due to outsourced technology assistance, and \$0.2 million due to travel costs, including corporate aircraft depreciation.

Realized Gains and Losses. Net realized gains (losses) resulted from the sale of equity securities associated with certain private finance investments and the realization of unamortized discount resulting from the sale and early repayment of private finance loans, commercial mortgage loans and CMBS bonds, offset by losses on investments. Net realized and unrealized gains and losses were as follows:

	For the Three Months Ended June 30,	
	2002	2001
(\$ in millions)		
Realized Gains	\$ 2.5	\$ 4.7
Realized Losses	(3.3)	(0.9)
Net Realized Gains (Losses)	\$ (0.8)	\$ 3.8
Net Unrealized Gains	\$31.6	\$ 0.2

Realized gains and losses for the three months ended June 30, 2002, resulted from various private finance and commercial real estate finance transactions. Realized gains for the three months ended June 30, 2002, primarily resulted from transactions involving two

private finance portfolio companies, Cumulus Media, Inc. (\$0.5 million) and Alderwoods Group, Inc. (\$0.1 million), and one commercial real estate investment (\$1.3 million). We reversed previously recorded unrealized appreciation totaling \$2.1 million and \$2.9 million when gains were realized for the three months ended June 30, 2002 and 2001, respectively.

Realized losses for the three months ended June 30, 2002, primarily resulted from transactions involving three private finance portfolio companies, iSolve Incorporated (\$0.9 million), Sure-Tel, Inc. (\$0.5 million) and Soff-Cut Holdings, Inc. (\$0.5 million), and one commercial real estate investment (\$1.1 million). We reversed previously recorded unrealized depreciation totaling \$2.0 million and \$1.5 million when losses were realized for the three months ended June 30, 2002 and 2001, respectively.

Unrealized Gains and Losses. We determine the fair value of each investment in our portfolio on a quarterly basis, and changes in fair value result in unrealized gains or losses being recognized. At June 30, 2002, \$2,381.0 million, or 93% of our total assets, represented investments recorded at value. Value, as defined in Section 2(a)(41) of the Investment Company Act of 1940, is (i) the market price for those securities for which a market quotation is readily available and (ii) for all other securities and assets, fair value is as determined in good faith by the board of directors. Since there is typically no ready market for the investments in our portfolio, we value substantially all of our investments at fair value as determined in good faith by the board of directors pursuant to a valuation policy and a consistently applied valuation process. Because of the inherent uncertainty of determining the fair value of investments that do not have a readily ascertainable market value, the fair value of our investments determined in good faith by the board of directors may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

There is no single standard for determining fair value in good faith. As a result, determining fair value requires that judgment be applied to the specific facts and circumstances of each portfolio investment while employing a consistently applied valuation process for the types of investments we make. Unlike banks, we are not permitted to provide a general reserve for anticipated loan losses. Instead, we must determine the fair value of each individual investment on a quarterly basis. We will record unrealized depreciation on investments when we believe that an investment has become impaired, including where collection of a loan or realization of an equity security is doubtful. Conversely, we will record unrealized appreciation if we have an indication that the underlying portfolio company has appreciated in value and, therefore, our equity security has also appreciated in value, where appropriate. Changes in fair value are recorded in the statement of operations as unrealized gains and losses.

As a business development company, we invest primarily in illiquid securities including debt and equity securities of private companies and non-investment grade CMBS. The structure of each debt and equity security is specifically negotiated to enable us to protect our investment and maximize our returns. We include many terms governing interest rate, repayment terms, prepayment penalties, financial covenants, operating covenants, ownership parameters, dilution parameters, liquidation preferences, voting rights, and put or call rights. Our investments are generally subject to restrictions on resale and generally have no established trading market. Because of the type of investments that we make and the nature of our business, our valuation process requires an analysis of various factors. Our fair value methodology includes the examination of, among other things, the underlying investment performance, financial condition and market changing events that impact valuation.